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In the Supreme Court of the United States

OCTOBER TERM, 1929

L. M. WILLCUTS, AS COLLECTOR OF INTERNAL REVENUE FOR THE DISTRICT OF MINNESOTA, PETITIONER

v.

CHARLES W. BUNN

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE PETITIONER

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In the Supreme Court of the United States

OCTOBER TERM, 1929

No. 535

L. M. WILLCUTS, AS COLLECTOR OF INTERNAL REVENUE for the District of Minnesota, petitioner

v.

CHARLES W. BUNN

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE PETITIONER

OPINIONS BELOW

The opinion of the District Court (R. 4) is reported in 29 F. (2d) 132. The opinion of the Circuit Court of Appeals (R. 15) is reported in 35 F. (2d) 29.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on September 23, 1929. (R. 17.) Petition for certiorari was filed December 23, 1929, and certiorari was granted on January 27, 1930. (R. 18.) The jurisdiction of this Court is based upon Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Is the imposition of a tax on income including gains derived by the owner of municipal bonds from the sale of such bonds at a profit unconstitutional to the extent of the inclusion of such gains?

STATUTE INVOLVED

Revenue Act of 1924, c. 234, 43 Stat. 253, 267 (U. S. C., Title 26, Sec. 954):

> SEC. 213. For the purposes of this title, except as otherwise provided in section 233—
>
> (a) The term "gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service * * * of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

While the Treasury Department has promulgated no formal regulations with respect to the inclusion in taxable income of a profit derived from the sale of state and municipal bonds, it has consistently ruled that such profits are taxable. The published rulings on the subject are set out in the Appendix.

STATEMENT

At various dates in the years 1919 and 1920 the respondent purchased for cash as investments cer-

tain bonds issued by various counties and cities in the State of Minnesota. The record does not disclose whether these bonds were purchased from a political subdivision or from some one else, nor does it appear whether the bonds were purchased at, above, or below par. In the month of January, 1924, the respondent sold these bonds and realized upon the whole transaction a net profit (disregarding interest accrued on coupons) of $736.26. He did not include any part of this profit in his income tax return. The Commissioner added this profit (less a net loss of $41.20 suffered by the respondent on certain similar bonds held less than two years) to the respondent's income, and assessed an additional tax of $85.44. This additional tax, together with interest amounting to $14.07, the respondent paid on demand under protest on May 8, 1928. He then filed a claim for refund which was rejected. (R. 2.)

The respondent filed his complaint in the United States District Court for the District of Minnesota (R. 1) and the petitioner demurred. (R. 3.) The District Court overruled the demurrer (R. 4) and, upon failure of the petitioner to answer, entered judgment for the respondent. (R. 8.) From this judgment an appeal was prosecuted to the Circuit Court of Appeals for the Eighth Circuit, which sustained the lower court. (R. 17.) Petition for certiorari was thereupon filed in this Court and certiorari was granted. (R. 18.)

SPECIFICATION OF ERROR TO BE URGED

The Circuit Court of Appeals erred in holding that Congress may not constitutionally impose a tax on income in so far as it includes gains derived by the owner of municipal bonds from the sale of such bonds at a profit.

SUMMARY OF ARGUMENT

The tax in this case, under the administrative construction of the Act by the Treasury Department, is not imposed on municipal bonds, or on the interest paid thereon whether or not in the form of discount, or on any income received pursuant to the bond contract. It subjects to the general provisions of the income tax laws only the gain derived by the owner from the sale of the bonds, over and above interest or discount.

The Circuit Court of Appeals held that such a tax caused an unwarranted burden upon or interference with the exercise by the municipality of its borrowing power upon the theory that the tax would affect the price at which the securities could be marketed. But it is submitted that the decisions of this Court have established the rule that such interference or burden must be obvious, appreciable, and not remote. Taxation has been sustained when imposed upon the transfer of estates, although measured by the value of the estate which included exempt securities. The same rule has been applied to taxes imposed upon the corporate privilege of doing business, although measured by the value of corporate property including exempt securities,

and dividends have been taxed although made up in part of interest from such securities.

The tax on gain derived from a transfer or sale is more remote in relation to the security than a tax on the transfer of a decendent's estate in which the security is included. The contingency of gain is an added condition precedent to the application of the tax.

That the injury is neither obvious nor appreciable is shown by the fact that the cost to states, counties, and municipalities has remained practically constant in a rising money market.

The burden or injury emphasized by the Circuit Court of Appeals is entirely theoretical and no tangible or practical burden has been demonstrated. The decision may be sustained only upon the theory that the United States may impose no tax which may even indirectly give rise to the slightest burden upon the marketing of municipal securities. So stringent a rule is contrary to the principles established by this Court.

ARGUMENT

The precise question presented is the constitutionality of a tax on income to the extent that such income includes gains derived by the owner of municipal bonds from the sale of such bonds.

Admittedly a Federal tax imposed on a municipal bond, or on the interest therefrom, is unconstitutional. *Pollock* v. *Farmers' Loan and Trust Co.*, 157 U. S. 429, 583. But a tax on income including profit derived from the sale of the bond is imposed neither on the bond nor on the interest. The sale of the

bond is a transaction wholly distinct from the contract between the municipality and the bondholder, and the profit or loss resulting from such sale neither increases nor decreases the liability of the municipality upon the bond. The tax upon such profit is not imposed upon the bond or obligation itself, or upon any income received pursuant to the provisions of the bond.

When bonds are sold by a municipality, the price is the then market price. The prospect of profit in excess of the interest or discount is not held out as an inducement. Possible profit from resale, as well as possible loss, depends upon eventualities. It is one of the risks accepted by the owner. The interest on the bond comes to the owner without further effort on his part. It is an exact obligation of the municipality, met with regularity. But gains or losses from sale by the owner result from a combination of factors, including business judgment and sagacity in purchases and sales. The gain, briefly, is derived from a combination of capital, industry, and skill. *Tax Commissioner* v. *Putnam*, 227 Mass. 522, 531. And the tax upon income, including such gain, is not a tax upon any sum received pursuant to the contract provisions of the bond. It is submitted that the use of the general term "income" in certain of the opinions of this Court dealing with the immunity of obligations of the States from taxation by the United States, or *vice versa*, is not controlling on the question of the immunity of the particular sort of "income" represented by such a gain.

The rulings of the Treasury Department set out in the Appendix (O. D. 647, 3 C. B. 123; O. D. 737, 3 C. B. 49; O. D. 762, 4 C. B 31) have consistently held that where a municipality originally issues a bond at a discount and redeems it at par, the return represented by the discount is interest in another form and not taxable, but the exemption has been limited to the amount of the discount, and profit resulting to the holder from a sale has been held taxable.[1]

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[1] It may be that the rule stated in O. D. 737, 3 C. B. 49, and O. D. 762, 4 C. B. 31, should be subject to some qualification. Since the difference between the amount a municipality receives from the issue of bonds at a discount and the par value paid at maturity is interest in another form, it should be distributed over the term of the bond. For instance, a four per cent bond maturing in five years is issued by a municipality at 95. The true interest rate (leaving aside the determination of present values, etc.) is five per cent. If the original purchaser holds the bond to maturity, he receives only interest and pays no tax. If, after holding the bond a year, at which time it would be worth 96 on the basis on which it was issued, the holder should sell at that price, the increase of one dollar in value would represent earned interest and would not be taxable. If he should sell at 95, he would suffer a loss of one dollar. On the other hand, if he should sell at 97, the profit of one dollar paid him by his purchaser would constitute a gain independent of interest and would be taxable. The tax on such gain is not imposed upon the bond itself or upon the interest or upon any income received under the terms of the contract with the municipality.

Whether the qualification above suggested or the rule as stated in the Office Decisions is the correct solution is immaterial in this case since it does not appear in this case that the bonds were issued at a discount.

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The decision of the Circuit Court of Appeals in the present case held that a tax upon income, to the extent that it included gain from the sale of exempt securities, was an unwarranted interference with and burden upon the exercise by the municipality of the vital function of borrowing money. This conclusion was based upon the premise that the tax would have an economic effect upon the price of such securities. It is submitted that this theory is applicable to the present case only if the United States is restrained by a rule, without exception, to the effect that it can not levy any tax which may, to the slightest perceptible degree, place a burden upon the marketing of municipal securities or to such degree render them less salable.

The case of *Plummer* v. *Coler*, 178 U. S. 115, demonstrates that the rule is by no means so stringent. In that case, this Court considered the question whether, under the inheritance tax laws of a State, a tax may be validly imposed on a legacy consisting of United States bonds issued under a statute declaring them to be exempt from State taxation in any form. The same contentions were there urged on behalf of the taxpayer, to the effect that the tax on inheritance would, by deterring individuals from investing in Federal securities, lessen the demand for such securities; that individuals would be driven to consider, when making their investments, whether they could rely on their heirs and legatees receiving United States bonds unimpaired by State action in the form of taxation; and that, if it should be held

that such taxation was lawful, capital would not be invested in United States bonds on terms as favorable as if the Court were to hold the tax invalid. The Court said (p. 137):

> But when the effort is made, as is the case here, to establish the unconstitutional character of a particular tax by claiming that its remote effect will be to impair the borrowing power of the government, courts in overturning statutes, long established and within the ordinary sphere of state legislation, ought to have something more substantial to act upon than mere conjecture. The injury ought to be obvious and appreciable.

The Court also said (p. 136):

> * * * the mischief to our national credit, so feelingly deplored in the briefs, caused by state taxation upon estates of decedents, would be inappreciable, and too remote and uncertain to justify us now in condemning the tax system of the State of New York.

See also, *Orr* v. *Gilman*, 183 U. S. 278. Conversely, Congress may require that municipal bonds be included in determining the value which is the measure of the Federal Estate Tax. *Greiner* v. *Lewellyn*, 258 U. S. 384.

The relation of the tax to the security in this case is, if anything, more remote than a tax on transfers of decedents' estates measured by a value which includes exempt securities. There the tax upon the transfer is certain if the value of the property reaches the statutory requirements. Here the tax is upon

net income including gain derived from a transfer in the form of a sale, and the contingencies of gain from the sale as well as the fact of net income in a taxable amount are added conditions precedent which render the prospective tax one step more remote.

Moreover, the injury here is neither obvious nor appreciable. The borrowing capacity of states, counties, and cities has not been curtailed. The estimated amount of securities issued by such bodies had grown by January 1, 1922, to the total of $8,142,000,000, then outstanding. (See *National Life Ins. Co.* v. *United States*, 277 U. S. 508, 532.) This amount equalled approximately one-third of the Federal indebtedness outstanding on June 30 1921, though that indebtedness embraced the entire war obligations of the Government. (See Annual Report of Secretary of the Treasury for 1921, pages 680 to 685.) But, in spite of this vast amount, the cost to states, counties, and cities of borrowed money has remained practically constant in a rising money market. (Grimes & Craigue, Principles of Valuation, 1928, p. 204.)

In *Nauts* v. *Slayton* (C. C. A. 6th), 36 F. (2d) 145 (in which the Government has applied for certiorari on another question), the court referred to the present case, and strongly indicated that in its opinion the question here presented is controlled by *Plummer* v. *Coler, supra*, and *Orr* v. *Gilman, supra*. The court said (p. 147):

> In that case [*Bunn* v. *Willcuts*] there was a holding that not only was the interest from

municipal securities exempt from federal taxation, but also that profit made from the purchase and sale of such securities is likewise exempt. Even were we to consider the question as not foreclosed by the holdings of the Supreme Court in *Plummer* v. *Coler*, 178 U. S. 115; *Orr* v. *Gilman*, 183 U. S. 278, it is not now before us.

In *Plummer* v. *Coler*, *supra*, this Court made a survey of decisions, both State and Federal, pertinent to the question under consideration. *Van Allen* v. *The Assessors*, 3 Wall. 573, is referred to with approval (p. 126) to the effect that it was competent for Congress to authorize the States to tax shares of banking corporations without regard to the fact that part or all of the capital of such institutions was invested in national securities which were exempt from taxation by State authorities. Again (pp. 126, 127), reference is made to *Society for Savings* v. *Coite*, 6 Wall. 594, and other cases, in which this Court affirmed the right of the States to impose a tax measured by the aggregate value of property of corporations even if United States bonds were included in such property. The same rule was applied to a tax measured by dividends where such dividends were partly composed of interest on United States bonds owned by the company. (See *Home Insurance Co.* v. *New York*, 134 U. S. 594, fully analyzed in *Plummer* v. *Coler*, *supra*, pp. 127–129.) A number of other cases were analyzed by the Court.

In *Flint* v. *Stone Tracy Co.*, 220 U. S. 107, this Court upheld the validity of a corporation tax

measured by the net income of the corporation which included interest from tax exempt securities. The Court said (p. 163):

> The distinction lies between the attempt to tax the property as such and to measure a legitimate tax upon the privileges involved in the use of such property.

Later the Court said (p. 165):

> It is therefore well settled by the decisions of this court that when the sovereign authority has exercised the right to tax a legitimate subject of taxation as an exercise of a franchise or privilege, it is no objection that the measure of taxation is found in the income produced in part from property which of itself considered is nontaxable. Applying that doctrine to this case, the measure of taxation being the income of the corporation from all sources, as that is but the measure of a privilege tax within the lawful authority of Congress to impose, it is no valid objection that this measure includes, in part at least, property which as such could not be directly taxed. See in this connection *Maine* v. *Grand Trunk Ry. Co.*, 142 U. S. 217, as interpreted in *Galveston, Harrisburg & San Antonio Ry. Co.* v. *Texas*, 210 U. S. 217, 226.

This Court, therefore, has repeatedly refused to declare the tax invalid where it is imposed, not on the securities or the interest therefrom, but upon the right to transfer by bequest, devise, or descent; or upon the right to do business; or upon some other right or privilege relating to a particular use of bonds

not growing out of the terms of the bond itself. Here, again, the tax is not upon the bond or interest, but upon the gain from sale. A tax upon gain derived from a transfer in the form of a sale does not appear to burden the sovereign right of borrowing to a greater degree than a tax upon a transfer by inheritance or a tax measured by net income including income from exempt securities.

The case of *Macallan Co.* v. *Massachusetts*, 279 U. S. 620, is not a limitation upon the principles established in *Plummer* v. *Coler*, *supra*, and *Flint* v. *Stone Tracy Co.*, *supra*. The rule in the *Macallan case* applies only where the real object is to impose a tax on exempt securities, and the taxing authorities make use of the form of a privilege tax merely as a medium to accomplish the ultimate purpose of taxing the exempt property. Here, the tax is levied upon net income generally, and the inclusion of gain from sale of exempt securities is merely incidental to the broader purposes of the law.

In *Metcalf & Eddy* v. *Mitchell*, 269 U. S. 514, this Court said (p. 523):

> In a broad sense, the taxing power of either government, even when exercised in a manner admittedly necessary and proper, unavoidably has some effect upon the other. The burden of federal taxation necessarily sets an economic limit to the practical operation of the taxing power of the states, and *vice versa*. Taxation by either the state or the federal government affects in some measure the cost of operation of the other.

> But neither government may destroy the other nor curtail in any substantial manner the exercise of its powers. Hence the limitation upon the taxing power of each, so far as it affects the other, must receive a practical construction which permits both to function with the minimum of interference each with the other; and that limitation can not be so varied or extended as seriously to impair either the taxing power of the government imposing the tax (*South Carolina* v. *United States*, 199 U. S. 437, 461; *Flint* v. *Stone Tracy Co.*, *supra*, at 172) or the appropriate exercise of the functions of the government affected by it. *Railroad Co.* v. *Peniston*, *supra* [18 Wall.], 31.

In *Heiner* v. *Colonial Trust Co.*, 275 U. S. 232, this Court considered the question of taxation of income derived by a non-Indian from a lease made to him by a tribe of Indians. The Court held (p. 235) that the exemption accorded to those instruments chosen by the Government to fulfill its duties to its Indian wards, as in *Gillespie* v. *Oklahoma*, 257 U. S. 501, was not available to others dealing with the Indians "merely because the statute, if applied as written, may have some perceptible economic effect on the Indians." Again the distinction is made between a tax on the instrument itself, and a tax which may have an incidental effect upon the Government or its activities.

The broad provisions of the income tax laws were intended to include income generally. *Irwin* v. *Gavit*, 268 U. S. 161, 166. It is clear that Section 213(a) of the Revenue Act of 1924, *supra*, is broad enough

to require gains from the sale of municipal securities to be included in gross income. The provisions of the Constitution will not preclude such tax unless the burden is obvious and appreciable. Every presumption is in favor of the constitutionality of an Act of Congress. *Nicol* v. *Ames*, 173 U. S. 509; *Stratton's Independence* v. *Howbert*, 231 U. S. 399; *St. Louis S. W. Ry.* v. *Arkansas*, 235 U. S. 350, 369.

Here, it is submitted, the burden or injury is so remote that, under the principles already established by this Court, the validity of the tax should be upheld.

CONCLUSION

It is respectfully submitted, for the reasons already assigned, that the Circuit Court of Appeals erred in holding that the tax in question was unconstitutional, and that the decision of that court should therefore be reversed.

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APRIL, 1930.

APPENDIX

O. D. 647, Cumulative Bulletin No. 3, July-December, 1920, page 123:

> Profit derived from noninterest-bearing State and municipal securities purchased at a discount and held until maturity is not taxable where it clearly appears that the return from the investment in the hands of the taxpayer is due solely to the compensation received from the State or municipality in lieu of interest for the use of the taxpayer's money. In no case may such exemption exceed the total discount at which the securities were originally sold by the State or municipality.

O. D. 737, Cumulative Bulletin No. 3, July–December, 1920, page 49:

> Profit derived from State and municipal securities purchased at a discount is not taxable in the hands of the person holding such obligations at maturity except that in no case may such exemption exceed the total discount at which the securities were originally sold by the State or municipality.
>
> Inasmuch as no person other than the municipality can pay the interest borne by the obligations of the municipality (whether such interest is paid at a specified rate or in the form of realized discount), any person selling municipal bonds for an amount in excess of the cost of the bonds to him (or their fair market value as of March 1, 1913, if they were acquired prior to that date) realizes a taxable profit to the extent of such excess amount even though the bonds were issued at a discount.

O. D. 762, Cumulative Bulletin No. 4, January–June, 1921, page 31:

> The M bank purchased certain 10-year 4½ per cent municipal bonds at 96.10 which had been originally issued and sold by the municipality at 94.50. The question is presented as to whether in case the bank sells the bonds before maturity at 98, the profit realized will be exempt in its hands.
>
> Held, that inasmuch as no person other than the municipality can pay the interest borne by the obligations of the municipality (whether such interest is paid at a specified rate or in the form of realized discount) any person selling municipal bonds for an amount in excess of the cost of the bonds to him realizes a taxable profit to the extent of such excess amount even though the bonds were issued at a discount.
>
> If, therefore, the bank sells at $98 the municipal bonds issued at $94.50 and purchased by it at $96.10 it will derive a taxable profit of $1.90 on each bond sold. If, however, it holds the bonds to maturity and receives $100, the difference between the purchase price of the bonds and the amount received or $3.90 will represent exempt income to it.

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